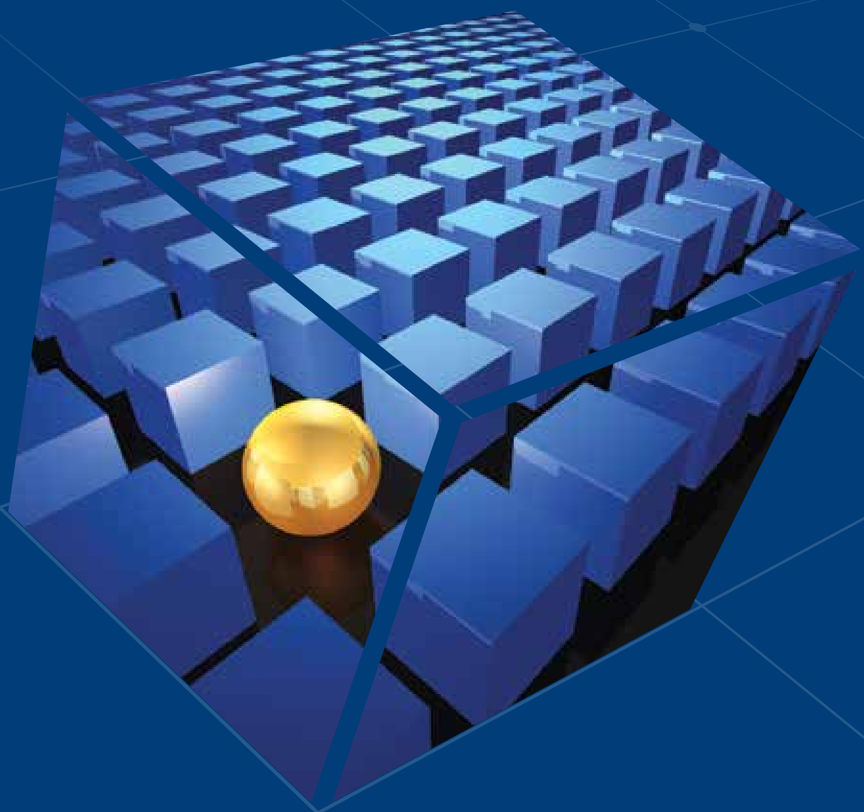
The Curious Role of the Executive Director



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Executive Summary

There is a voluminous literature focusing on the role of non-executive directors, and the contribution they make to company performance.

But the UK unitary board structure relies on there being a significant number of executive directors as well. Their role, as directors rather than as managers, is easily overlooked.

Appointment to the board should not simply be a feather in the cap of a successful executive, a sign that they've reached the top. Promotion to the board brings with it a complex set of duties and responsibilities that are distinct from those of senior managers.

How companies prepare their top managers for those additional duties, while ensuring they are kept in balance with the loyalty they rightly owe to the chief executive and their other management colleagues, is a central theme of this paper.

Promoting senior managers to the board can be valuable from an executive development and succession planning point of view.

Equally, questions of board size and management cohesion must be considered, requiring both the chair and chief executive to engage in a complex set of trade offs.

Executive Directors – An Increasingly Rare Breed

The UK unitary board is so called because, in contrast to the two-tier board structure popular in continental Europe and elsewhere, it unites both executive and non-executive directors within a single decision-making body.

For this structure to work, there must be a sufficient complement of executive directors to ensure that the full board is well informed about the operation of the business, and to subject the senior management team to regular and healthy challenge.

While the UK remains committed to the concept of the unitary board, in reality board structure has changed radically in the two decades since the Cadbury Code took effect. Until the Cadbury governance reforms of 1992, executive directors typically made up half the board, and indeed were often in the majority.

Board balance has shifted dramatically since. Today, half of all FTSE 100 companies have only the chief executive and finance director as management members of the board. In the FTSE 250 index, about two-thirds of companies have only those two officers serving as directors.

Of the 189 executive directors on the boards of the 350 largest companies who are neither the chief executive or finance director, most are divisional managing directors. Chief operating officers are widely represented, while there are twelve company secretaries, four chief investment officers, three human resources directors and two chief technology officers.

The companies with the largest complement of executive directors are Euromoney Institutional Investor and Prudential, which have appointed six and five executive directors respectively.

The fact that the ranks of executive directors have thinned so substantially in the past 20 years owes much to the increased focus on boards' governance responsibilities and the 'professionalisation' of the role of non-executive directors. But has something been lost along the way?

This paper explores the critical ways in which executive directors add value to the board, addresses the obstacles to appointing multiple executives directors and asks how, in an era of smaller and more heavily non-executive boards, the most valuable aspects of the unitary structure can be preserved.

Executive Director – the Emphasis is on *Director*

The Companies Act draws no distinction between executive and non-executive directors. Both are equally responsible and liable for the long-term success of the business.

In practice, this means that executive directors must take a view of the whole company when entering the boardroom, as opposed to limiting their perspective to either their divisional or functional role.

This point was echoed by one FTSE 100 executive director we spoke to: "A board role takes up time and requires executive directors to think about the business in ways that they didn't have to before. When they meet the investors, they have to be able to talk about the plc as a whole."

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When you join the board, however, you are expected to add value and take a strategic, company-wide view."

Multiple Executive Directors – the Advantages...

The premier advantage of appointing additional executive directors to the board beyond the chief executive and the finance director is to give the board additional insight into the operation and performance of the business, especially in a complex, multinational company.

A current chair (and former group chief executive) we spoke to concurs: "I always thought that a chief executive and a finance director was the right mix. But I was persuaded that there are some very big bits of the business that need to be present on the board."

A broader range of executive directors on the board can allow the non-executives to read patterns of speech and body language that might reveal tension or disagreements in the ranks of management. This can be critical in terms of judging the ability of the chief executive to lead his team, and the confidence in which she is held among the top echelon.

As one of our commentators put it: "A large executive team keeps the chief executive honest – there's no telling one thing to the non-executives and another to the executive committee."

Widening the pool of executive directors is also valuable from the perspective of professional development and succession planning. One FTSE 100 chair re-iterated this point: "In terms of CEO succession, you're in a difficult position if there is no internal candidate who has served as an executive director on the board."

A second added: "If you have a high-flying manager, you may need to give him a board seat for retention reasons. If you don't, he can be lured away for an executive job elsewhere."

A board seat is also valuable from the perspective of the individual executive. Not only does a board seat confer prestige and prominence, it also enhances the possibility of a non-executive directorship elsewhere and perhaps a fruitful 'plural' career in career in due course.

...and the Disadvantages

Of course, identifying the lead internal candidate to be the chief executive's successor may not always be clear-cut.

And what of those senior managers who are not promoted to the board? Selecting some individuals for a board seat while not affording the same preferment to colleagues with roughly equal responsibilities can be divisive.

From our conversations, it is precisely to avoid being forced to choose favourites that many companies have opted to restrict executive board seats to the chief executive and finance director.

Executive directors who join the board may also find it is difficult to be critical of other divisions. "You don't want to seem like you are sticking your nose in to the day job of your executive colleagues," says one former FTSE 100 executive director. Likewise, non-executive directors may hesitate robustly

to challenge the chief executive in front of other executive colleagues for fear of undermining them.

Appointing a large group of executive directors can also prompt an 'us v. them' culture, with executives and non-executives lined up on either side of the boardroom table. An executive team that thinks and speaks 'en bloc' is hardly conducive to good debate.

There may of course be a simpler reason for limiting the number of executive directors – board size. Although larger executive teams can provide the board with greater coverage of different divisions within the business, there comes a point when larger boards can suffer from coordination and communication problems and board effectiveness may decline.

Given the obligations of the UK Corporate Governance Code, every executive director needs to be matched by a further non-executive. If the preference of the chair is for a relatively small, cohesive board of 7-8 people, then it becomes difficult to widen the pool of executive directors.

For those companies that prefer to keep the number of executive directors at board meetings to a minimum, an essential counterbalance is to ensure the chair and non-executive directors are in regular contact with those senior managers who do not serve on the board or attend board meetings.

Whether joining for board dinners, presenting regularly to the board or merely observing board or committee meetings, senior managers can gain plentiful executive development and 'board readiness' without necessarily having a formal seat at the table.

Preparing Executives for Life in the Boardroom

At a minimum, newly minted executive directors should be made aware of the specific duties and liabilities that come with a board seat

If the position of executive director is viewed as separate and discrete from that of executive manager, it follows that individuals should be properly prepared for and inducted into the role.

Again, what is viewed as standard practice for bringing non-executive directors on to the board is often overlooked when it comes to their executive colleagues.

In researching this paper, we found evidence of excellent planning and succession. One FTSE 100 executive director told us that he'd been given two years' notice of his potential promotion to the board, time that was then used to develop his relationships with the non-executive directors, introduce him to large investors, and broaden his understanding of the parts of the business he knew less well.

At the other end of the spectrum, another former executive director told us he was informed by his chief executive that he'd been promoted to the board but that he was not welcome to attend board dinners and should refrain from speaking in the board meeting unless absolutely necessary.

At a minimum, newly-minted executive directors should be made aware of the specific duties and liabilities that come with a board seat. A session with the general counsel or external legal advisers on directors' duties is a must.

Likewise, a detailed conversation with the company secretary on how the chair structures the board agenda through the year, the balance of responsibilities between

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the board and the various committees and perhaps some de-personalised highlights of the most recent board evaluation will give a new director a sense of the board's culture, style and preferred way of working.

The chair should be sure that any new director is properly prepared. This point is echoed by one former FTSE 100 executive director: "Before joining the board, I had a long session with the chairman and one of the non-executive directors where we went through their expectations of me in the role."

Executive directors should recognise that board debates, and the questioning and areas of challenge they can expect from non-executive directors, may be quite different to what they are used to at executive committee.

One board director told us: "You have to learn to listen. If something's going away from you, don't jump in emotionally. You have to appreciate the point of view that the non-executives are coming from."

Another adds: "Executive directors have to understand that non-executives understand half of what you think they do. Probing and challenging questions from non-executives should not be confused with criticism or considered a test of their knowledge."

The Chief Executive Relationship

Executive directors face a potentially awkward conflict of loyalties. As directors, they have statutory duties to the company; as a manager, however, they owe direct, personal loyalty to their immediate boss, the chief executive.

Chairs and non-executive directors should be alive to this potential for tension, looking out not only for signs that the chief executive has become over-mighty or other symptoms of dysfunction but also for evidence of too much 'cosiness' within management ranks.

One executive director we spoke to shared this view: "Within the executive team, my loyalties are clearly to the chief executive and my colleagues. If you're an executive director, and you're not loyal to the chief executive, it is hard to see how you can help deliver the strategy."

An executive team that presents a common front, but is also capable of open and healthy differences of opinion, suggests a chief executive confident in their abilities and those of their team. Conversely, a chief executive who brooks no disagreement from executive colleagues may struggle to build long-term relationships of trust.

As with boards of directors as a whole, management teams should operate on the basis of open debate and challenge, coupled with a commitment to collective responsibility when a decision has been reached.

One executive director echoed this sentiment: "We'll certainly have healthy debates, but by the time we get to the board, we'll have an agreed position. If there are disagreements, the chief executive will be aware of what they are and will be happy to share it with the board. The key is no surprises."

An accomplished chief executive adds: "Executive directors should be broadly aligned on strategic issues, but it is not a requirement. If you have a different view, put it across."

Conclusion

As boards have become smaller over the past decade and governance reforms have served to increase the complement of non-executive directors, executive directors are an increasingly rare breed.

But diminishing numbers should not detract from the critical role of executive directors – as directors, not as managers – in ensuring board effectiveness.

It is the executive directors, after all, who know the business best, understand the day-to-day challenges of delivering the strategy, and represent the strongest internal candidates for any chief executive succession.

At the very least, executive directors represent a vital resource on which the chair and non-executive directors may draw.

Of course, senior managers do not need to be directors to engage productively with the board. It is increasingly common practice for the board to range widely in terms of the executives it invites to observe or present at the board, or to attend board dinners.

But the UK remains committed to a unitary structure that brings both executive and non-executive directors together in the same body, and there appears little appetite for following the US model where the chief executive is frequently the only management director.

While that remains the case, the role of the executive director should be more widely understood and discussed. We hope this paper helps to open the debate.

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